

Thrift Deposit Institutions in Europe and the United States

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The history of development of
U.S. and European thrift
deposit institutions (banking
for the poor) yields lessons for
today's developing countries.

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Summary findings

The financial systems in most developing countries today have many features in common with the financial systems of the developing countries of the eighteenth and nineteenth centuries. Whether they had unlimited liability (as in Scotland in the eighteenth century), or limited liability and special charters, commercial banks dominated European and U.S. financial systems. Moreover, they were typically established by wealthy people and oriented toward businesses and other wealthy people — they effectively represented “banking for the rich by the rich.” Insurance companies were underdeveloped and pension and mutual funds did not yet exist. As a result, middle- and low-income people had limited access to formal financial services and relied on informal arrangements for borrowing. Meanwhile, financial savings were unproductively hoarded under the mattress.

In developing countries today this gap in the provision of financial services can be explained by the low level and unequal distribution of income and wealth, high information and transaction costs, and weak enforcement mechanisms. In Europe and the United States, over time, different types of institutions — including savings banks, credit cooperatives, building societies, and credit unions — emerged to fill this market gap. Many developing

countries have created institutions that specialize in lending to the poor, but more must be done to help these institutions reach the poor in rural areas and assist small farmers, artisans, and traders.

An integrated program to build solid institutions requires five elements for success:

- Strong leadership. (Support should be given to groups, such as the Church or local officials, likely to attract people with integrity, high ideals, and commitment to the institution’s success.)
- A three-tier structure.
- Strong emphasis on education and the dissemination of information about the workings and benefits of the institution. (Culture can be an obstacle to a thrift institution’s success, as the Irish experience shows.)
- An official policy that encourages self-help and avoids total reliance on external funding. External support could be made dependent on local resource mobilization and a record of monitoring and repayment.
- Most important, the encouragement of active peer monitoring and the enforcement of contractual obligations. The principle of unlimited liability may not be viable in most developing countries, but government could support only regional units and local institutions that have a good record of loan repayment.

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by

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This paper was presented at a World Bank Seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, Reforming Finance: Some Lessons from History, edited by Gerard Caprio, Jr. and Dimitri Vittas. The author wishes to thank the participants at that seminar and the editors for their comments.

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The financial systems in most developing countries today have many features in common with the financial systems of the developing countries of the eighteenth and nineteenth centuries. Whether they had unlimited liability (as in Scotland in the eighteenth century), double liability (as in the United States in the late nineteenth century), or limited liability and special charters, commercial banks were the dominant institutions in the financial systems of European countries and the United States. Moreover, they were typically established by wealthy people and oriented toward businesses and other wealthy people—they effectively represented "banking for the rich by the rich." Insurance companies were underdeveloped and pension and mutual funds did not yet exist. As a result middle- and low-income people had limited access to formal financial services and relied on informal arrangements for borrowing. Meanwhile, financial savings were unproductively hoarded under the mattress.

In developing countries today this gap in the provision of financial services can be explained by the low level and unequal distribution of income and wealth, high information and transaction costs, and weak enforcement mechanisms. But over time, different types of institutions, including savings banks, credit cooperatives, building societies, and credit unions, emerged in the United States and Europe to overcome these problems and fill this market gap. This chapter gives a brief historical review of the emergence and evolution of thrift deposit institutions in Europe and the United States and draws lessons for today's developing countries.²

². The term thrift deposit institution is used to distinguish these bank-like institutions from the mutual insurance companies that have also encouraged thrift and played a large part in the evolution of financial

The Origin of Thrift Deposit Institutions

Several types of thrift deposit institutions developed and their ownership, functions, and orientation differed substantially across countries and across types of institutions. Some institutions were established as publicly owned units, others were mutually owned by their members, and others were set up as foundations.

Some institutions focused on mobilizing deposits from low- and middle-income groups and holding them in government debt. This pattern was followed by postal savings banks in all countries and by ordinary savings banks in countries (such as the United Kingdom and France) where government regulation required them to invest all their deposit funds in government debt. In still other countries, such as Germany, Italy, the Netherlands, Sweden, Switzerland, and the United States, savings banks were allowed to lend to firms and households (although in the United States regulations differed from state to state). Credit cooperatives were set up by farmers in rural areas and by artisans and small traders in urban areas. Their main purpose was to mobilize resources for lending to their members. Finally, building societies, savings and loan associations, and credit unions specialized in raising deposits from households and then lending the funds back to them for housing finance and consumer credit needs.

The heyday of thrift deposit institutions was probably the mid-1970s. In the past twenty years pension funds and mutual funds have become very important in the financial systems of many countries. As a result, the relative importance of both commercial banks and thrift deposit institutions has declined. Although pension funds and mutual funds are similar in many respects—their members share in the returns and costs of their operation—their modes of operation are quite different.

systems. The achievements and shortcomings of mutual insurance companies have mirrored those of thrift deposit institutions.

In addition to the growth of these institutions, the industrial world has also witnessed a process of "demutualization," whereby highly profitable and successful institutions have converted to stock ownership.

These conversions have taken place on top of the takeovers and conversions of failed institutions, especially in the United States in the wake of the savings and loan debacle. These conversions have contributed to the relative decline of thrift deposit institutions.

The conversion of mutual savings and loan associations and mutual savings banks into stock institutions has been very extensive in the United States, dating from at least the early 1960s. Demutualization of building societies began in the 1980s and has progressed farthest in Australia, New Zealand, and South Africa, and is now spreading in the United Kingdom. The demutualization of mutual insurance companies has also begun to take place in the United States, the United Kingdom, and other countries. Continental Europe and Japan have not yet followed this trend, although the pressures on mutuals are growing in all countries.

Conversions and demutualizations are taking place at this juncture for several reasons. They reflect the need to finance expansion with external capital, particularly in new areas of business in which mutual institutions are diversifying away from their traditional operations. They also reflect the fact that in most of these institutions, mutuality has long become a myth—most of their "owners" do not see themselves as members of a movement but rather as customers of well-established financial institutions. And, finally, they reflect the opportunistic behavior of managers who more often than not are the main beneficiaries of conversions. Whatever the combination of reasons in different countries, recent trends identify the mid-1970s as the heyday of thrift deposit institutions.

Internationally comparable data on the relative size of thrift deposit institutions are not readily available. A study conducted in the late 1970s on the deposits and other liabilities with the nonfinancial sector showed that thrift deposit institutions accounted for between one-third and one-half of total liabilities

with the nonfinancial sector in Germany, France, Italy, and Japan—all countries in which insurance companies and pension funds played a very small part in the financial system (at the time). But even in the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States, where institutional investors were more developed, thrift deposit institutions accounted for between one-fifth and one-third of all financial sector liabilities (table 9.1). Also, the share of large commercial banks was not very large even in countries such as the Netherlands and Sweden, where banking concentration was very high.

In the United Kingdom and the United States, building societies and savings and loan associations played an important role, but credit cooperatives did not emerge, and savings banks accounted for small shares of all resources mobilized (table 9.1). In contrast, savings banks were very large in Germany and Switzerland and only slightly smaller in Italy, Sweden, and France. Credit cooperatives were large in Japan, France, and the Netherlands and to a lesser extent Germany and Italy. Postal savings banks, including postal giros, were more important in France than in Japan, but they were also very large in Italy and the Netherlands. Finally, credit unions were large, at least as formal institutions, only in the United States.³

Why did thrift deposit institutions emerge in most European countries and the United States and how were they able to grow and acquire such importance in the financial systems of so many countries? What was their contribution to financial sector development and most broadly to economic development? And what is their relevance for the financial systems of developing countries, many of which have encouraged the development of similar institutions but with far less satisfactory results? These questions are examined after a description of the development of thrift deposit institutions in different countries.

³. Note: The data in the table are based on published statistics in different countries. If the institutions were very small, statistics were not collected or published. Such was probably the case of credit unions in the United Kingdom and building societies in France.

Ordinary Savings Banks

Ordinary savings banks, so named to distinguish them from postal savings banks, came in two forms: banks that were required to invest all of their funds in government debt and banks that enjoyed greater freedom in their investment policies through expanded lending powers. The first category included savings banks in the United Kingdom and France, and the second savings banks in the United States (at least in some states), Germany, Switzerland, and other European countries.

Savings banks were largely created in response to the orientation of commercial banks toward industry and commerce and the wealthier segments of society. They encouraged thrift by providing safe and convenient outlets for the savings of wage earners and other low-income groups. But the motivation for creating savings banks was not purely altruistic. There was also concern about the impact of relief given to poor on government and municipal funds. It was felt that if the poor could be encouraged to save, they would put less of a burden on wealthier segments of society. But, although they were established to provide safe deposit facilities for the poor, and indeed initially put upper limits on the size of deposit accounts, savings banks in most countries deviated from this orientation early on and sought deposits from wealthier people.

Savings banks met with considerable success in most countries, largely because of their low transaction costs. Transaction costs were lower because of the simpler and more limited range of services provided and the reliance on unpaid staff. For example, in their early years savings banks were open only a few hours on one or more days a week, did not encourage withdrawals, and did not operate through full branches. In New England (and also in Australia) savings banks shared the same facilities as commercial banks and represented little more than special windows that were open a few of days a week. Over time, savings banks became more business-like, were run by professional staff and managers, and developed their

own branch networks. Although their relative efficiency in terms of transaction costs declined, savings banks were favored by a preferential fiscal regime, both with regard to the deposit facilities offered to their customers and with regard to the taxes they had to pay on their operations and profits.

Savings Banks in Germany

The first German savings bank was founded in 1768 in Brunswick followed by the establishment of one in Hamburg in 1778 (Cahill 1913:75). From there they spread quickly to several other German cities as well as to Swiss cities such as Bern and Zurich. Most German savings banks were public institutions, established by municipal and other local authorities and operated under their tutelage and guarantee, although their charters were approved by their respective state authorities. However, a few savings banks were established by private associations.

Savings banks were founded to prevent the poorer classes from falling into absolute poverty by providing a place for the safe deposit of small sums of money. The first such banks were established in connection with efforts to reform the poor laws. Because they catered to the needs of low-income groups, most savings banks initially placed upper limits on deposit balances. In addition, they provided no credit facilities for depositors, as this service would have contradicted their stated purpose. Moreover, savings banks were required to invest in safe securities, and lending to poor workers was not considered safe.

About 280 savings banks had been established in Germany by 1836, and their number grew to 1,200 by 1850. The number of deposits held in savings banks increased steeply with the acceleration of industrialization after 1860. By 1913 the deposits in the 3,133 German savings banks amounted to nearly 20 billion marks. The eight big joint-stock banks held only 5 billion marks (Born 1983:107). In order to facilitate deposits and withdrawals, the savings banks established large branch networks and collecting

agencies. These totaled well over 7,500 units in 1910, which, including head offices, created a total network of more than 10,000 outlets (Cahill 1913:77).

The creation of savings banks in Germany was motivated not only by the desire to provide savings outlets for low-income groups, but also by the pragmatic consideration that municipal funds for poor relief would be less strained if the poor accumulated savings. But the establishment of health insurance in 1883 and old-age and disability insurance in 1889 eroded part of the original rationale for creating savings banks, and they increasingly became the banks for middle-class depositors. Unlike their counterparts in Britain and France, German savings banks were not required to deposit their funds with the state treasury or to invest in government bonds, and they began to give credit to small-scale manufacturers and artisans even in the early phase of their development. In 1911 about 60 percent of their deposits were invested in mortgage loans, secured on urban (40 percent) and rural property (20 percent). Slightly less than 25 percent of funds were invested in securities, and a very small proportion were invested in personal loans (Cahill 1913:75).

The maximum amount of deposits was set by each bank and their guaranteeing authority. As banks increased these limits over time in order to attract deposits from wealthier people, they introduced notice requirements—two-week, four-week, three-month, and six-month—that put limits on the amounts that could be withdrawn. These limits were not always upheld, but they provided a useful weapon of defense in times of monetary pressure. Given that they were funded from short-term deposits, savings banks were granting short- to medium-term mortgages that were effectively interest-only loans with a recall option. They were also able to vary the rate of interest on the loans in response to changes in market rates.

At the turn of the century the banks were under pressure to develop mortgages with annual sinking-fund payments. These were different from modern, annuity-type mortgages, in which capital is reduced on a monthly basis. Instead, sinking-fund mortgages accumulated a fund in an interest-bearing deposit account. But sinking funds created problems with respect to their rate of interest and their availability to

borrowers. In some cases sinking funds earned interest at the same rate as mortgage loans, in others at the rate of savings deposits, and in still others at an intermediate rate. Sinking funds were not supposed to be available to borrowers and were often used to reduce the loan balance once a certain round sum was accumulated. But if borrowers were allowed to use the sinking funds for other purposes, any interest credited to them was adjusted to the rate paid on ordinary savings deposits.

Savings banks made mortgage loans for up to 50 percent of the value of urban properties and 66 percent of the value of rural land. Valuations were either based on appraisals prepared by specialized mortgage credit banks and insurance companies or, in the case of farm land, on approved multiples of the net yield declared for tax purposes. There were no laws or regulations restricting mortgage loans within their respective districts. But the multiples allowed were generally greater for properties located in the same district as the bank than for properties in other districts. Also, the loan-to-value ratios were higher for properties in the same district than for those in other districts. In order to encourage the creation of small holdings, savings banks were prepared to use higher loan-to-value ratios (up to 75 percent or even 85 percent) for small holdings and allotments in their own district, provided that at least half of one percent of the principal amount of the loan was repaid annually.

An important feature of German savings banks was their three-tier structure. Savings banks operated in local areas delineated by their guaranteeing authority but were supported regional central giro institutions, which were in turn linked to a national giro institution. The three-tier structure emerged after 1908, when the savings banks were given the right to negotiate checks and proceeded to establish local giro associations for cashless payment transactions. A giro association was formed in every Prussian province and federal state by the municipal authorities. These associations founded central giro institutions as clearing centers for their affiliated banks. The central giro institutions also managed the liquidity reserves of individual banks and provided a mechanism for transferring funds from savings banks with surplus

resources to those with excess demand for funds. The first central giro institution was created in Saxony in 1909. In 1918 a national giro institution was founded as the center point for all giro institutions. Thus, the savings banks were united through this large nationwide giro network and also gained access to money and capital markets.

Despite their public ownership, German savings banks operated very effectively. They were hit by the hyperinflation of the 1920s, but were able to survive because of their local authority guarantees. Following the currency reform, their savings deposits, mortgage loans, and mortgage bonds were all reduced to 25 percent of their book value, and the savings banks were able to resume their expansion. In 1930, 70 percent of their assets were long-term loans in the form of mortgages and public sector debt, including loans made to local authorities. But they also maintained substantial liquid funds with their giro institutions and provided short-term credits. In conjunction with the central giro institutions, the savings banks became universal banks that competed with commercial banks, particularly for the business of medium-size enterprises and middle-income households.

Savings banks have always funded their long-term loans and bonds with short-term deposits. This practice has exposed them to interest rate risk, a problem from which they continue to suffer. But because of their state guarantees and their strong liquidity positions, they have been able to survive, albeit suffering from periods of poor profitability. Today, German savings banks are under pressure because they are publicly owned and because they need external capital to finance expansion. There are calls for their privatization and eventual absorption into the commercial banking sector, but it is not clear if and when any privatization will take place.

Savings Banks in Britain

Unlike in Germany and other European countries where savings banks were founded with the explicit support of local authorities, the initiatives to form savings banks in Britain came from private individuals, mainly clergymen and wealthy philanthropists. The first British savings bank was established by the Reverend Henry Duncan in Ruthwell, Scotland in 1810. Reverend Duncan played a central role in advocating savings banks for lower-income groups. But the Ruthwell Savings Bank was predated by an earlier initiative in London. In 1804 the Tottenham Benefit Bank was established to enable poor people in Tottenham to safely deposit their savings in an institution that was guaranteed by "a few respectable persons of property." According to Born (1983), this institution paid 5 percent interest per year, but in its first years did not invest its funds, and the interest was paid out of the pockets of the "respectable persons" who managed its business (Born 1983:108).

The number of savings banks in the United Kingdom grew to twenty-six by 1815, seventy-eight by 1816, and 465 by the end of 1818 (Olmstead 1976:6). They were established as private institutions, but were bound by law to deposit their funds with the department of national savings, which invested these funds in government bonds. The rate of interest paid to savings banks was often higher than the coupon rate on government bonds, although bond holdings suffered losses when interest rates rose. During the Crimean War the value of bonds held on behalf of the savings banks had a shortfall of 4 million British pounds against total savings deposits of 9 million pounds. But the savings banks were insulated from these losses. By 1861 their number had increased to 638, although following the creation of the Post Office Savings Bank in that year, many savings banks closed down. Their number fell to 483 by 1873 (Born 1983:109).

Attempts to expand the lending and investment powers of savings banks were frustrated—not least because of opposition from the established commercial banks—until the mid-1970s, when the trustee savings banks were reorganized and their powers expanded. They were subsequently merged into one group that culminated in the 1987 flotation of the TSB Group as a full-fledged, stock-owned universal

financial institution. Despite the restrictions on the utilization of their deposit funds, the trustee savings banks were able to expand in number and along branch networks and to diversify into many ancillary services, including both mutual fund management and insurance services.

Savings Banks in France

The first French savings bank was the Caisse d'Epargne de Paris, which was founded in 1818 by the directors and shareholders of an insurance company. More than 350 savings banks were established by 1845, mainly by private groups or municipal authorities. French savings banks were required to place their deposits with the Caisse des Depots et Consignations, a state institution founded in 1816 and accountable to the French Parliament.

When an individual's deposit reached 50 francs, it had to be converted into a perpetual state annuity in the holder's name. Thus savings banks funds were used to finance the public debt, partly in the form of floating debt and partly in form of perpetual annuities. But perpetual annuities created liquidity problems and losses for the banks if they had to be sold in times of crisis and at low values.

Despite these recurring problems, the savings banks appealed not only to low-income groups but also to wealthier segments of the population. To maintain the low-income orientation of savings banks, the government imposed upper limits on deposit accounts. Over time, the French savings banks, like their counterparts in the United Kingdom, developed extensive branch networks and diversified into ancillary services. Benefiting from low transaction costs, fiscal incentives, and the controls on interest rates on retail deposits, they continued to account for a large share of household deposits, although in the last decade they have suffered from the emergence of money market mutual funds and the growing popularity of mutual funds and life insurance policies.

Savings Banks in the United States

Savings banks in the United States appeared a few years after those in the United Kingdom and at more or less the same time as those in France. The first institutions to begin operating were the Philadelphia Saving Fund Society and the Provident Institution for Savings in Boston, both of which opened in 1816. The Savings Bank of Baltimore was organized in 1818 and the Bank for Savings in the City of New York in 1819 (Payne and Davis 1956:12-18).

These institutions were strongly influenced by the success and rapid expansion of savings banks in the United Kingdom. They were established by men who were active entrepreneurs not only in insurance and commercial banking but also in industry and commerce. Yet despite their backing by prominent personalities in the business world, the first application to obtain a charter for a savings bank in New York was rejected "in consequence of the principles not being distinctly comprehended and the preponderant objection against the incorporation of any more banks" (Krooss and Blyn 1971:61). The petition was rejected because it aroused the opposition of the antibank group, and for this reason the supporters of savings institutions in Philadelphia and Boston avoided using the word bank in their title.

The number of savings banks increased quickly as this institutional innovation spread to other eastern and mid-Atlantic states. By 1820 there were ten savings banks with more than \$1 million in deposits. Their number rose to fifteen by 1825 and to fifty-two by 1835, with more than \$10 million in deposits. But their business was very unevenly distributed. More than half of the deposits were made with New York savings banks, while about three-quarters of New York savings deposits were held with the Bank for Savings.

As in other countries the U.S. savings banks were at first founded to "ameliorate the condition of the poorer classes" (Bank for Savings) or to "aid and assist the poor and middling classes of society in putting their money out to advantage" (Philadelphia Saving Fund Society). In line with their primary

objective to provide deposit facilities for the poor, some savings banks restricted the size of deposits and some paid declining graduated interest rates (a lower rate for balances above a certain limit). Savings banks in New York and most other states were subject to investment constraints that forced them to invest in federal government debt or in local state and city bonds. The Bank for Savings in New York played a crucial part in financing the construction of the Erie Canal. In 1821 it held 30 percent of its stock, which was tantamount to a public bond (Olmstead 1972:824). Banks in Massachusetts and Maryland were not required to invest in public sector bonds, although they were prohibited from investing in bonds of other states or from lending to corporations or people residing in other states. But even these banks initially placed their deposits in safe investments, mostly local state and city bonds. Savings banks also deposited their funds with commercial banks.

Gradually, but very early in their history, the restrictions on deposits and investments of savings banks were dismantled. Thus, Pennsylvania repealed the restriction on the size of deposits in 1824, and New York permitted mortgage loans in 1830. Savings banks began to reorient themselves toward wealthier groups, especially those banks that were more concerned with safety than growth. They expanded their business hours and began to move out of public sector bonds and into loans secured by mortgages or securities and even into loans based on personal security. By 1825 the Baltimore Savings Bank had put three-quarters of its assets in security and personal security loans. These loans were concentrated among a small group of merchants. In Massachusetts loans on personal security accounted for about one-quarter of assets in 1835 (Krooss and Blyn 1971: 62).

The Massachusetts Hospital Life Insurance Company was created in 1823 as a life insurance company but operated more like a savings bank or a trust. It was founded by prominent Bostonian financiers and industrialists to provide income for the Massachusetts General Hospital and to offer savings bank services for the rich and middle classes. Contrary to early savings bank practice, this institution did

not take deposits of less than \$500 for less than five years, and it discouraged the business of those who could take care of their own affairs. The Massachusetts Hospital Life Insurance conducted very little life insurance business, but became known as the "Great Savings Bank." It became the largest financial institution of its day and was the most important source of medium-term finance for New England industry, especially the textile industry (Davis 1960:8). The first president of the Massachusetts Hospital Life Insurance was William Phillips, who was also president of the Massachusetts Bank and the Provident Institution for Savings. Ebenezer Francis, who was the driving force behind its creation, was a director of the Boston Bank and later the first president of the Suffolk Bank (Krooss and Blyn 1971:58-9).

Savings banks were the fastest growing financial institutions in the United States by the middle of the nineteenth century. Their deposits grew from \$10 million in 1835 to \$150 million in 1860. Although they continued to attract deposits from low-income groups, their customers also included wealthy people. In addition to federal, state, and city bonds, savings banks were investing in corporate securities and making business and mortgage loans. In the mid-1850s well over 50 percent of New York savings bank assets were in government securities and more than 40 percent were in mortgages. In Massachusetts loans on personal security and mortgages accounted for 60 percent of assets. But the savings banks suffered from liquidity problems during the crisis of 1857, and they were forced to build up their liquid assets, shifting their focus to government bonds.

Nevertheless, savings banks continued to expand until the crisis of 1873. After 1873 many savings banks suspended their operations, and although total losses were small, there was a sharp swing toward conservatism. In New York regulations were imposed, limiting investments to government bonds and mortgage loans for less than 50 percent of appraised value. In other states savings banks faced increasing competition from commercial banks, which started to attract depositors with interest-bearing time deposits, and from building and loan associations.

The relative importance of mutual savings banks declined after 1890, mainly because they failed to take root in the fast-growing West. Between 1860 and 1890 their assets grew from \$150 million to \$1.7 billion. But after 1890 their growth decelerated sharply, and by 1922 their assets amounted to only \$6.6 billion. In comparison, savings and loan associations held \$2.8 billion and commercial banks \$47 billion. During this period savings banks operated in sixteen states but only played an important role in New England and the mid-Atlantic states.

Unlike the public savings banks in Germany and other Central European countries, which were promoted by forward-looking public officials, and the savings banks in the United Kingdom and France, which were fostered by clergymen and wealthy philanthropists, savings banks in the United States were mostly championed by men of industry and finance. As a result there were extensive interlocking directorships among the management of savings banks and that of commercial banks, insurance companies, and industrial and commercial enterprises. Over time, these interlocking positions gave rise to close links between savings banks and the financial and industrial establishment. And as a result savings banks provided considerable funds for financing industrial and commercial firms.

The most telling examples were the savings banks in New England, which were the most important suppliers of long-term finance to the textile industry. Savings banks provided 40 percent of all new long-term loans during 1840-60 to the eight leading textile mills. Trust companies provided 29 percent of the total, commercial banks only 4 percent, and individuals contributed 22 percent (Davis 1960:6). Moreover, the savings banks charged lower interest rates on these long-term loans than the rates prevailing in the shorter-term markets, and they always observed the usury ceilings on interest rates. Savings banks also held corporate stock, and they were major stockholders of New England commercial banks. The close links between commercial and savings banks were evident from the sharing of branch facilities: savings banks

were little more than special windows of commercial banks that were open a few days a week. Savings bank depositors benefited from this arrangement because of lower transaction costs.

Davis (1960) noted that banks in the United Kingdom or in the western United States tended to withdraw from affected markets when faced with binding usury ceilings, forcing firms to borrow from unregulated sources. Usury ceilings thus had the unintended effect of raising the effective cost of funds for industrial and commercial firms. Davis also noted that in the face of binding usury ceilings, nonprice rationing must have played an important role in finance. As a result firms that had good connections with savings banks through interlocking directorships obtained finance on more favorable terms than firms with no such connections. In particular, new industries "may well have found loan finance almost impossible to obtain through traditional channels in times of credit stringency" (Davis 1960:4).

One explanation for the behavior of savings banks is that they were provincial in their lending policies, preferring to keep their investments where they could be closely watched rather than seeking higher returns in out-of-state operations (Payne and Davis 1956:110-13). This pattern was seen among savings banks in all states and also reflected the pattern observed in Germany. The provincialism in investment policy and the geographic concentration of assets was one manifestation of the immobility of long-term capital in the United States until the last part of the nineteenth century (Davis and Payne 1958:404). This immobility could be attributed to the information problems that affected lending to or investing in companies located in other states.

But another explanation holds that the directors who managed the affairs of savings banks did not attempt to maximize the returns on their investments, but were quite happy to lend these funds to their own textile companies at below market rates (Vatter 1961:216-21; Olmstead 1974:816). This explanation challenges the purely altruistic motivation of the founding men, who claimed to want to establish and manage savings banks for the sole benefit of the poorer classes (Payne and Davis 1956:20-21). Instead it

suggests that these institutions became as useful to the founders and managers as to the people for which they were ostensibly established. Olmstead (1974:816) raised the question of whether their objectives changed over time as they grew in importance. Their reorientation toward wealthier depositors lends some support to this view.

Even the Savings Bank of New York, which was not allowed to invest in nongovernment securities, was affected by the close links between the promoters and directors of the Savings Bank and the promoters of the projects that the Bank financed (Olmstead 1976). Several of the directors helped to plan projects that the Bank financed, while in other cases they actively prodded government planners to proceed with social overhead investments by assuring officials that finance from the bank would be forthcoming (Olmstead 1972:810). The directors stood to gain large nonpecuniary (and possibly indirect pecuniary) benefits from the success of the projects they so actively sponsored. Nevertheless, Olmstead (1974:834) concluded that the trustees of the New York Savings Bank were attempting to maximize the real rate of return on their portfolios, given legal constraints. Their primary objective was to pursue their depositors' interests, despite the many conflict-of-interest situations that arose. Olmstead also noted that state governments reaped substantial benefits from the investment constraints imposed on mutual savings banks in the form of lower interest payments on their entire debt. Moreover, the early constraints were instrumental not only in channeling savings bank assets into the financing of the Erie Canal, but also in indirectly helping to attract funds from other investors who entered the market only after the canal was partially opened, and was not nearly so risky a venture. The initial success of New York State in financing its public works encouraged other states to embark on similar projects (Olmstead 1972:838).

Postal Savings Banks

Although savings banks were initially established to provide safe deposit facilities for low-income groups, their reorientation toward high- and middle-income groups early in their development and their lack of extensive branch networking prevented them from filling the gap in savings facilities. To meet this need postal savings banks were established, the first in the United Kingdom in 1861. It was followed by Japan in 1875, France in 1881, Austria in 1883, and the United States in 1910 (Born 1983:337).

Postal savings banks were created in order to encourage saving by low-income groups. Although they paid a modest interest rate (in Britain the rate was lower than that paid by the trustee savings banks), their main attractions were safety, since they had the explicit backing of the state, and convenience, as they operated through nationwide networks of post offices. The services offered by postal savings banks were often complemented by postal giros, which offered money transfer services through the post offices. Postal giros took the lead in many European countries in the late 1950s in automating payment services and offering more efficient clearing services.

Unlike postal giros, which are mostly found in Central and Northern European countries, postal savings banks were created in almost all countries. Their record in mobilizing resources has varied from modest to impressive, and their relative success can be attributed to a number of factors. For example, they have done better in countries where commercial banks and other competing institutions had small branch networks (such as in Japan), or in countries where they have enjoyed fiscal advantages that were denied to their competitors (such as in France). In Japan commercial bank networks have been subject to strict official regulation, in France only deposits with the postal and ordinary savings banks have benefited from fiscal incentives. The relative importance of postal savings banks has been greatest in the former communist countries, where they had the monopoly on collecting household deposits. Despite establishing the first postal savings bank, postal savings in the United Kingdom did not grow very large relative to the

domestic financial system, mainly because commercial banks, building societies, and trustee savings banks were able to develop large branch networks and to offer more attractive deposit facilities.

The most successful postal savings bank has been the Japanese bank, which, on the basis of resources mobilized, is by far the largest financial institution in the world. Its total deposits amount to nearly 1.5 trillion dollars at current rates of exchange—more than three times bigger than the assets of the largest banks. The success of the postal savings bank in Japan is often attributed to the fiscal advantages conferred on deposits of up to 3 million yen. But this explanation is not correct because the fiscal incentives applied for all small deposits, not just those made with the postal savings bank. The success of the postal savings bank came mainly from the convenience of its vast branch network (only in the 1980s did the branch networks of all other deposit institutions match that of the post office) and, to a lesser extent, from the safety of explicit government backing. Safety was more important in the past, when bank runs afflicted the Japanese financial system. But it was clearly less important in the past fifty years as official Japanese policy sought to prevent the failure of any bank. The importance of the safety factor was shown during the banking crisis of April 1927, when thirty-seven banks were unable to meet demands for deposit withdrawals. As a result, deposits at the five biggest banks increased by about 30 percent within a year of the crisis and by about 28 percent at ordinary savings banks, which were not affected by the crisis. But the deposits of the postal savings banks almost doubled in the same period (Born 1983:253).

Until recently, postal savings banks were required to place their deposit funds in government debt. This requirement converted such deposits into a captive source for financing government budgets, and in many countries the returns offered to depositors were highly negative in real terms. But in recent years

there has been a trend to expand the lending powers of postal savings banks and in some cases to merge them with existing commercial banks or to convert them into full-fledged commercial banks.⁴

As long as postal savings deposits were channeled to government agencies, their contribution was limited to the mobilization of resources. Their contribution to investment and economic development depended on the efficiency and effectiveness of their and other government agency operations. It is sometimes argued that the success (or alleged success) of policy-based finance in Japan was attributable to the reliance on postal savings for financing policy-based lending operations. To the extent that using postal savings was less inflationary than using commercial bank deposits or central bank credit for such operations, this argument would be valid. But many other countries have used postal savings for policy-based operations, and their results were far inferior to those of Japan. The relative success of Japanese credit policies should be attributed to their more efficient management of credit programs and, in particular, to the greater effectiveness of monitoring final borrowers' use of funds. But it cannot be denied that, as long as safety, convenience, and low transaction costs are important factors, postal savings banks can make an important contribution in encouraging thrift, especially among lower-income groups, and in mobilizing financial resources.

Credit Cooperatives

Credit cooperatives, in particular the Raiffeisen banks, were hailed as the most wonderful institutions in the world by a report of a U.S. Commission that studied European agriculture in the first decade of the

⁴. For example, in Sweden the post office savings bank was merged with a previously state-owned commercial bank to form the PK Bank in 1974. More recently, the PK Bank was merged into the Nordbanken. In the Netherlands the postal savings bank was first merged with the postal giro to form the Postal Bank in the late 1970s. The new bank was later taken over by another commercial bank, which itself was subsequently taken over by the ING group, a financial conglomerate with interests in both banking and insurance.

twentieth century (Metcalf and Black 1915). Similarly, positive views were also expressed in a U.K. report on German agriculture (Cahill 1913). This favorable assessment was not affected by the disputes and divisions that afflicted the movement in Germany. It reflected the success of credit cooperatives in mobilizing resources and offering credit services to German farmers, artisans, and small traders and the avoidance of failures. As in the case of savings banks, these institutional innovations generated considerable interest in other countries and they quickly spread to several neighboring countries.

Credit cooperatives were created to meet the credit needs of small farmers in rural areas and those of artisans and small traders in urban areas, thus protecting them from the high rates charged by moneylenders. Like savings banks, credit cooperatives benefited from low transaction costs, as they often operated out of the kitchen of a farmer and relied on unpaid managers and staff. In addition, because of their reliance on local knowledge and peer monitoring, their loan losses were unusually low.

Credit cooperatives used the joint and several unlimited liability of members to raise funds from nonmembers and to make loans on the security of the character, moral worth, industry, sobriety, and thrift of their members, reinforced by peer pressure and mutual oversight. Thrift was motivated by the principle of unlimited liability and contributed to a high loan repayment record. Effective peer monitoring was facilitated by the small size and small area of operation of most credit cooperatives.

Credit cooperatives were championed by men of high integrity and social standing, such as clergymen, wealthy philanthropists, or public officials. The protagonists emphasized self-help and developed a three-tier structure. Regional units facilitated the flow of funds across individual cooperatives and also provided valuable audit and control services, while national units represented the joint interests of credit cooperatives and provided a link to national money and capital markets. Urban credit cooperatives, whose area of operations were large, abandoned the concept of unlimited liability very early in their

development. But all types of credit cooperatives emphasized the need to accumulate reserve funds to be used during times of difficulty.

Despite the clear advantages enjoyed by credit cooperatives in terms of lower transaction and information costs and lower loan losses, Guinnane (1993:1) noted that their critics in Germany and elsewhere argued that their success was not attributable to their higher efficiency but rather to their reliance on local boosterism in the form of unpaid managerial labor. In addition, critics accused credit cooperatives of being patronage devices through which local elites controlled poor people's access to credit and, with it, their customers, laborers, and so on. But the great success of these institutions in the ensuing 100 years strongly suggests that these criticisms overly exaggerated any underlying tendencies of patronage and control.

Credit Cooperatives in Germany

Credit cooperatives were first established in Germany in the 1840s. The first cooperatives were urban credit cooperatives founded by Hermann Schulze-Delitzsch, which catered to the needs of artisans and small traders. The first rural credit cooperatives were established in the 1860s by Friedrich Wilhelm Raiffeisen and Wilhelm Haas. These institutions were oriented toward farmers and other people living in small villages. Both types of cooperatives initially had unlimited liability. After the passing of the law on credit cooperatives in 1889, most urban cooperatives gradually adopted limited liability, but rural cooperatives continued to rely on unlimited liability. Both types of credit cooperatives experienced rapid growth.

By the mid-1860s eighty urban credit cooperatives were operating with nearly 20,000 members. A general association of trading and economic cooperatives was created in 1864 to represent their joint interests, while a central cooperative bank was also established in the same year in Berlin as a partnership limited by shares. Although the purpose of the central cooperative bank was to act as a clearinghouse for

credit cooperatives—accepting their deposits and granting them credits on current accounts—credit cooperatives made little use of its services, and the central cooperative bank engaged in ordinary commercial and investment banking. But it suffered substantial losses in this business and it was merged with the expanding Dresdner Bank in 1904. Despite the problems of their central cooperative bank, urban credit cooperatives continued to expand. Their number rose to 740 with more than 300,000 members by 1870 and to 1,500 with more than 800,000 members by 1913. More than 1.5 billion marks in credit was provided in 1913 (Born 1983:111-12).

The number of rural credit cooperatives also increased very rapidly. There were thirty such cooperatives by 1866 and about 100 by 1872, when Raiffeisen created the first central cooperative bank for rural credit cooperatives at Neuwied. Two more central banks were founded by Raiffeisen in quick succession and all three were united to form the German Agricultural General Bank in 1874, which was a registered society with unlimited liability. But Schulze-Delitzsch objected to the creation of a central bank without share capital and took the matter to the courts. As a result, the central bank for rural cooperatives was dissolved and reconstituted in 1876 as a joint-stock company called the German Agricultural Central Loan Bank (also referred to as the Central Raiffeisen Bank). It was owned by societies that participated in the Federation of Raiffeisen banks.

The rural credit cooperatives were further divided in 1877 between those founded by Raiffeisen, who favored the creation of a three-tier structure with considerable central control in order to level out the differences between poor and rich cooperatives, and those founded by Haas, who defended the independence and autonomy of individual cooperatives and wanted to limit the role of central bodies to the representation of common interests, counseling, and cash audits. Despite this division, the number of rural credit cooperatives continued to expand, reaching more than 1,700 by 1890 and nearly 17,000 by 1913, when they had a total membership of 1.5 million (Cahill 1913:98). Their total assets amounted to 3 billion

marks, representing about 5 percent of the total assets of German banks (Guinnane 1994b:43). By 1913 fifty-two regional central banks were operating in addition to two national ones: the Central Raiffeisen Bank and the Prussian Central Cooperative Bank, a state bank that was established in 1895. The total assets of all credit cooperatives accounted for 8 percent of all banking assets in 1913.

The creation of central banks intensified the "system dispute" between Schulze-Delitzsch and Raiffeisen. Opposition to a central bank with unlimited liability was based on the argument that individual societies should not assume double unlimited liability—their own and that of other societies. But another source of system dispute had to do with the use of share capital and entrance fees. Although both Schulze-Delitzsch and Raiffeisen favored unlimited liability and the accumulation of reserves to strengthen the solvency of credit cooperatives over time, urban cooperatives introduced share capital, which, together with accumulated reserves, would provide a first buffer, while the joint unlimited liability of members would provide a second line of defense. Raiffeisen was opposed to levying entrance fees and the institution of share capital, as they would have prevented poorer farmers from joining.

In the early days of credit cooperatives three types of liability structure were discussed: unlimited liability, unlimited contributory liability, and limited liability. Unlimited liability implied that members were individually and collectively responsible for the debts of the cooperative. In case of insolvency the cooperatives would first apply a per capital levy on all members. But if the cooperative still had unsettled debts after three months, creditors could sue individual members for the full amount of the debt. Although members had a right of restitution from the cooperative, if other members were much poorer, the likelihood of recovery would be very small. For this reason joint and several unlimited liability made more sense in communities where all members were small farmers and had more or less equal financial means.

The concept of unlimited contributory liability was introduced by the law of 1889. Under this arrangement per capita levies could be imposed on members, but creditors could not start proceedings

against individual members. Contributions not recovered from individual members, owing to their insolvency, could be divided equally among remaining members. Thus members' liability continued to be unlimited, but the process of debt recovery would be subject to a long and tedious procedure that undermined the ability of cooperatives to raise debt from nonmembers. This form of liability was adopted by only a small number of cooperatives.

Limited liability involved both the purchase of a share in the cooperative and the agreement to pay an additional predetermined fixed sum of money in case of insolvency (this was similar to the concept of double liability that prevailed in commercial banks in the United States in the second half of the nineteenth century). In Saxony and Pomerania, where most rural credit cooperatives with limited liability were found, the additional liability was between forty and fifty times the nominal value of each share. In these two provinces landowning members had suffered from the collapse of some urban credit cooperatives with unlimited liability. When limited liability was legalized by the act of 1889, it was adopted by rural credit cooperatives to counter the mistrust of landowners (Cahill 1913:114-20).

Because of their different orientation, urban and rural credit cooperatives developed different operating characteristics. The urban cooperatives focused on short-term lending, operated in bigger areas, and had larger membership. After the adoption of limited liability, which was probably made necessary by the wide area of operations and large membership and therefore the inability of members to monitor each other, some urban credit cooperatives were faced with solvency problems from bad loans. In contrast, most rural credit cooperatives had a small membership and operated in a narrow and well-defined area. This set up facilitated peer monitoring and supported the maintenance of unlimited liability. From the outset, rural cooperatives were able to make loans for five to ten years, repayable in installments. The security was the character of the borrower, the purpose of the loan, and two other members as sureties. Between 1895 and 1910 only nineteen rural credit cooperatives out of 10,000 were involved in bankruptcy proceedings.

During the same period there were sixty-nine cases of insolvency among the more than 1,000 urban credit cooperatives, and a total of 386 bankruptcies among 6,000 ordinary commercial banking and credit undertakings (Cahill 1913:118).

The concept of unlimited liability was supplemented by the creation of a three-tier structure to ensure the good performance and stability of rural credit cooperatives (Guinnane 1994b). The three-tier structure enabled rural cooperatives to overcome their funding exposure, which arose because they made long-term loans from short-term deposits. Credit cooperatives were also vulnerable to liquidity problems that could be caused by a shock affecting all members in a local area. The regional cooperatives provided liquidity management and funding as well as auditing services that increased the general creditworthiness of credit cooperatives. They also forced discipline on individual cooperatives and kept fraud and mismanagement under control.

This impressive record inspired the authors of the report of the American Commission from the State of Washington to describe the Raiffeisen system as the most wonderful system in the world, "capable of creating capital out of nothing," and to assert that "moral character, industry, sobriety, and thrift were better security than property!" The enthusiasm with which the Raiffeisen banks were greeted in Europe is exemplified by several statements from the sponsors of credit cooperatives in Italy. The first statement was made by Luigi Luzzatti, who established the first urban credit cooperative in Milan in 1865:

The rural bank, which arose without capital, rich only in its invisible treasure of mutual trust and human solidarity, is the fruit of the modest, unrecognized virtues of the country folk, bound together by bonds of mutual affection, who assist and watch over each other with the subtle vigilance of neighbors. And, lo and behold, these humble folk, void of economic lore, have accomplished a miracle, due to the fact that a moral and not a material

impulse guided their work, the miracle of creating capital out of nothing. (Metcalf and Black 1915:114)

Luzzatti also declared:

The security of a cooperative bank is the moral character of its members. To make these banks secure, we have to make the lazy man industrious, the drunkard sober, the improvident thrifty, and even the illiterate educated. (Metcalf and Black 1915:115)

The third statement was made by Leone Wollemborg, who founded the first Italian rural credit cooperative in Loreggia in 1883:

Suppose you have 100 small working farmers, all possessing honesty, industry and labor capacity; this is their only capital. A capitalist might with safety make them a loan of fifty francs each; but some of these men will certainly be afflicted with sickness, death or lack of employment. It is impossible to say which will thus be unable to pay, but it is certain that it will only be a certain proportion. Experience has shown that 98 will pay. In order to meet the liability, the group must undertake to become responsible for the other two who are likely to be unable to pay. There will be 98 men to repay the loan made to 100. They will thus be able to assume responsibility for a loan of 49 each instead of 50, for they will have to assume responsibility for the two unable to pay and by making themselves collectively responsible for the loan, they will be able to make it for 49 multiplied by 100. It is thus seen that the mathematical formula on which these banks are able to secure their capital is nothing more than an application of the same principle which governs insurance. Therefore unlimited liability is the first principle. The other principle is limitation of the area of operations, restricting it to certain localities, and this limitation of area also constitutes the justification of the principle of unlimited liability. It would not be fair to

expect a man to make himself responsible for a loan, the use of which was beyond his control. But when the loans are strictly limited to people residing in the same locality, all can become vigilant and act as inspectors for their own protection. And you will find that inspection thus exercised is far superior to any government inspection, since each man has been rendered personally liable and is acting as inspector in his own interest. As one of the farmers said: 'We are 100, all acting as spies on the others to see that nobody does anything wrong.' (Metcalf and Black 1915:68)

Credit Cooperatives in Other European Countries

These observations were based on the German experience as Luzzatti was a student of Schulze-Delitzsch and Wollemborg a student of Raiffeisen. Despite extolling its virtues, Italian credit cooperatives did not adopt unlimited liability because peasants were ignorant of the workings of organized credit and men owning property were unwilling to become liable for poor neighbors without property. Nevertheless, credit cooperatives made considerable progress in Italy. The growth of rural cooperatives was stimulated by the cooperation and support provided by savings banks and by urban credit cooperatives, known in Italy as "people's banks". Credit cooperatives spread in several other European countries, such as Austria, Belgium, France, Hungary and other Eastern European countries, and Switzerland. Credit cooperatives were also well developed in Canada, although they eventually evolved into credit unions.

As in the case of savings banks, credit cooperatives were promoted in most countries by clergymen, wealthy philanthropists or, as in the case of Schulze-Delitzsch and Raiffeisen, local officials and politicians. In general, the promoters emphasized self-help and opposed relying on government financial assistance, except for publicity and education. France was the one exception—the credit agricole was supported by a

substantial loan from the Bank of France. This condition was imposed by the government on the Bank of France as a condition for renewing its charter in 1897.

There was an intriguing contrast in authorities' attitudes in Germany and in France. When the cooperative movement was founded in Germany, the authorities were at first opposed to it. The King of Saxony forbade the first convention of cooperative societies called by Schulze-Delitzsch at Dresden in 1859. Moreover, both William of Prussia and Bismarck were hostile, seeing cooperation as an insidious form of socialism intending to undermine government. But, later on, in view of the success of the cooperatives and their contribution to the prosperity of the rural population, the attitude of the authorities became very favorable and supportive (Metcalf and Black 1915:22).

In France the creation of credit cooperatives was promoted by Louis Durand who studied the Raiffeisen system and began to establish in 1893 what were known as the "caisses Durand." But the republican government of the time perceived the caisses Durand to be a ploy of reactionary forces that were associated with the Catholic church. To preempt their initiative, the government enacted a law that promoted the creation of both local and regional agricultural banks that were effectively established along departmental lines and thus subject to political control (Bonin 1992:29-32). The regional banks played a key part in rediscounting the bills of local banks and distributing central bank credit to local banks established in accordance with the provisions of the republican law. The availability of state credit and perhaps also the fact that the credit cooperative system was developed from the top down generated a low level of deposits, as farmers preferred to deposit their money with the savings banks (Metcalf and Black 1915:230-35).

After World War I the French authorities passed legislation that encouraged the creation of "banques populaires" by merchants, craftsmen, and professionals in order to increase the supply of credit to the middle class. A Caisse Centrale des Banques Populaires was founded in 1921 followed by the Chambre

Syndicale des Banques Populaires, which intended to strengthen the control and supervision of individual banks, which had suffered many failures. In addition, measures were taken to consolidate and expand the operations of agricultural credit cooperatives, of which there were already more than 4,000 by World War I.

The Caisse Nationale de Credit Agricole was created in 1920, and it helped expand the number of rural credit cooperatives to about 10,000, of which about two-thirds belonged to the favored public network and the rest consisted of caisses libres (Born 1983:240-241).⁵

Credit cooperatives did not meet with much success in the United Kingdom and Ireland. Several reasons were advanced for the failure of credit cooperatives in the United Kingdom. First, the large branch networks established by joint-stock banks made credit facilities available to a larger number of farmers than in other countries, implying that fewer farmers relied on loans from moneylenders at high rates. Second, farmers had access to trade credit from suppliers. Third, unlimited liability was unpopular in the United Kingdom, where limited liability by share capital was widespread. Fourth, average farmers and small holders were allegedly unwilling to disclose their financial condition to their neighbors and were also allegedly reluctant to borrow in cash (as distinct from trade credit, given in kind) (Metcalf and Black 1915:258). Another possible factor was the greater concentration of land ownership and larger size of farms in the United Kingdom, implying that there were fewer small landholders than in other countries.

In Ireland, although Irish bankers argued that credit cooperatives failed simply because there was no need for them, other observers maintained that credit was expensive for small holders and credit cooperatives could have been a solution to the problem. The failure of credit cooperatives in Ireland has been attributed to several factors (Guinnane 1994a). First, because most cooperatives were established with

⁵The Caisse Nationale de Credit Agricole played a central role in the distribution of subsidized credits to French farmers after the end of World War II. Today, the French Credit Agricole, like the Dutch Rabobank, are among the largest universal banks in Europe.

unlimited liability, they didn't attract the more prosperous locals whose burden in case of insolvency would have been unequal with respect to poorer members. However, the absence of prosperous locals deprived the credit cooperatives in Ireland of the monitoring and expertise that was a crucial factor for the success in Germany. Second, Irish cooperatives failed to develop the central banks that were a feature of the German system. Although credit facilities were obtained from the state and from joint-stock banks, the failure to develop strong central auditing federations deprived Irish cooperatives of the discipline and good record keeping found in Germany.

Third, Irish farmers were reluctant to force their neighbors to repay their loans or face adverse consequences. Thus a major rationale for the creation of credit cooperatives, the discipline exerted by peer monitoring, was absent in Ireland. Fourth, Irish farmers were reluctant to borrow from credit cooperatives and thus disclose their financial position to the entire community. In contrast, German farmers were reportedly happier borrowing from their local credit cooperatives than from banks. Irish farmers were even reluctant to place deposits with credit cooperatives and thus expose themselves to pressures to extend personal loans or to act as cosigners for loans. Because the Post Office Savings Bank was established in the United Kingdom and Ireland before credit cooperatives, the need to provide deposit and savings facilities in rural areas that were not well served by commercial or savings banks—one of the rationales for their emergence in Germany—was not pressing. Another important factor may have been the purchase of land by tenant farmers that was made possible through government mortgages. Although mortgage payments were probably lower than land rents, the assumption of large debt sharply reduced the ability of farmers to borrow from other sources.

The experience of Irish credit cooperatives supports the arguments made explaining credit cooperatives' lack of progress in the United Kingdom. The failure of credit cooperatives in Ireland also

underscores the importance of cultural and educational factors, the importance of sequencing institutional innovations, and the difficulties of transplanting institutions and practices from one country to another.

Building Societies and Savings and Loan Associations

In several continental European countries savings banks and credit cooperatives as well as mortgage credit banks were able to expand into mortgage banking and housing finance. They thus filled the gap in the provision of housing finance to middle-income people that was created by the orientation of commercial banks toward industrial and commercial companies and wealthy individuals. But in the United Kingdom and the United States (as well as several other Anglo-American countries, such as Australia, New Zealand, South Africa, and to a lesser degree Canada), where savings banks and credit cooperatives were either not successful or not allowed to engage in lending, building societies and savings and loan associations emerged to fill this gap. These institutions specialized in the provision of housing finance but funded their operations from short-term deposits rather than long-term bonds.

Building societies and savings and loan associations (initially known as building and loan associations) had common roots and followed fairly similar paths of development, at least until the Great Depression (Vittas 1992). They originated in the early terminating societies that appeared in Britain in the second half of the eighteenth century and in the United States in the first half of the nineteenth century. The early terminating institutions were followed in both countries by serial institutions and then by permanent institutions. In both countries they suffered from fraud and mismanagement, and the instruments used were very similar.

Early building societies in the United Kingdom and building and loan associations in the United States were created as cooperative ventures, established by relatively wealthy merchants, craftsmen, and professionals to enable cooperative members to buy homes. As terminating institutions, they wound up

their operations once all members achieved their goal. Each member agreed to make regular subscriptions until a relatively large sum of money was collected. This rule implied that these institutions were established for relatively long periods (usually slightly less than twelve years, but ranging between ten and fourteen years) and that members were able and willing to undertake long-term commitments.

An apt description of how terminating institutions operated is given by the rules of the Oxford Provident Building Association, which was the first U.S. building society, founded in 1831 in Frankford, Pennsylvania (Bodfish and Theobald 1938:30-39). This association also underscored the common roots of thrift institutions in the two countries, since the Oxford Provident was established by two English-born manufacturers and an English-born doctor in association with a lawyer and a school teacher, who also was a surveyor and conveyancer. The rules of the Oxford Provident stipulated that members had to subscribe for between one and five shares, each having par value of \$500. They were required to pay an initial \$5 for each share subscribed and then \$3 a month on each share. A member was entitled to borrow \$500 for each share held. Whenever \$500 was accumulated in the treasury of the association, a loan of that amount was offered to the member who bid the highest premium. Loans were not made for building houses more than five miles from the market house in Frankford or outside of Philadelphia County, and no member in arrears on his contributions or fines was allowed to bid for a loan. Borrowers were charged a flat fee of \$3 to cover the costs of examining title papers and make disbursements in accordance with progress in the construction of the house being financed. Borrowers were required to pay \$2.50 a month for the loan, equal to an annual rate of interest of 6 percent, in addition to their \$3 monthly contribution. A fine of 25 cents was imposed on members who failed to pay their contribution and an additional 25 cents on borrowers who failed to pay their monthly interest.⁶

⁶The Oxford Provident had thirty-six members when it was organized who subscribed for a total of forty shares (four members subscribed for two shares each and the others for one). The highest premium bid for the first loan was as much as \$10 but the first borrower, who was a lamplighter, was unable to keep up with

Despite the problems they faced, the number of building societies increased quite rapidly, although early records were far from comprehensive. Between 1780 and 1820 sixty-nine societies were founded, and in the ensuing fifty years more than 3,000 societies were created. But because most societies were of the terminating type, only about 1,500 societies were operating in 1869. In the United States building and loan associations grew slowly at first, but they took off after the 1870s, becoming the main type of thrift institution in most states outside of New England. They experienced very rapid growth in the late 1880s, their number increasing from around 2,000 in 1888 to more than 5,000 in 1893.

The great strengths of early societies were their mutual character and the high degree of mutual trust among their members. Every member was equally involved in the affairs of the society as lender, borrower, and office holder (members took turns holding office). Monthly meetings were held at inns and were considered social events as well as business meetings. But early building societies faced many problems, such as ensuring that members paid their dues, permitting withdrawals, accommodating new members, supplementing their funds with borrowing in order to accelerate the granting of mortgage loans, utilizing surplus funds, and so on. Serial terminating institutions provided a partial answer to these problems, but it was the advent of permanent building societies (and permanent building and loan associations) that enabled the separation of borrowers and investors and allowed these institutions to extend loans for fixed terms and to raise funds through shares and deposits on different terms and conditions.

But these innovations weakened the institutions' mutual character and gave rise to imprudent and fraudulent behavior. The history of building societies in the nineteenth century is replete with episodes of

his payments, and his membership, property, and obligations to the association were transferred to another person. The Oxford Provident was terminated in 1841, more or less as originally planned. A second Oxford Provident was almost immediately established with seventy-nine members and shares with a reduced par value of \$200 and monthly contributions of \$1. The second Oxford Provident was terminated in 1851 and was followed by a third one set up in 1852, which evolved into a serial association.

such behavior and of changes in legislation that sought to establish better prudential standards. With the growth in the number of permanent societies, loans started to be made on security other than houses, with some societies providing advances against more speculative properties, such as factories. Advances to speculative builders were also made, exposing societies to considerable losses when builders went bankrupt.

Many societies borrowed excessive amounts to finance their operations. Few of them had an adequate capital structure or held enough of their assets in liquid form. Because funds could be withdrawn on demand, severe problems were created when a society failed and depositors made a run on other societies. Competition led to even more generous advances and less-careful selection of securities. Geographic diversification involved lending in distant locations, where lack of knowledge of local conditions created problems with the evaluation of properties and assessment of borrowers' credit-worthiness.

Accounting practices also left much to be desired. In particular, the treatment of discounts on advances created difficulties. Many societies gave advances to borrowers who accepted the largest discount on the nominal amount of the advance. These discounts were then treated as realized profit available for distribution to members instead of being amortized over the life of the advance. This practice had an adverse impact on the long-term performance of societies because the returns to members in later years were much lower and because borrowers with speculative and more-risky ventures tended to offer the largest discounts.

Several societies experienced an increase in fraudulent activities both internally (by officers) and externally (by borrowers). Lack of adequate supervision allowed directors and officers to take out society funds for their personal use. In some cases borrowers defrauded societies, usually by overstating the value of properties, with the help of officials. Outsiders, such as builders and solicitors, engaged in fraudulent activities involving dummy purchasers and forged deeds.

The advent of permanent building societies and building and loan associations was also associated with a geographic expansion of operations that led to the emergence of "nationals," that is, institutions with operations in several regions or states. Unlike savings banks and credit cooperatives in continental Europe, building societies in the United Kingdom and savings and loan associations in the United States did not establish a three-tier structure that would have allowed geographic diversification of risk without loss of local knowledge and thus obviated the need for nationals. Nationals engaged in more aggressive competition and adopted sharper practices that in many cases involved outright fraud and mismanagement.

In Britain the most serious fraud involved the Liberator Society, a London-based society that had risen to become the largest in the movement. At the time of its failure in 1892, the Liberator was nearly twice the size of its nearest rival. In a situation reminiscent of the worst offenders in the savings and loan debacle of the 1980s, the Liberator had only 2 percent of its mortgages in ordinary advances when it failed; the vast majority were in second and third mortgages to companies controlled by its director. The collapse of the Liberator had an adverse impact on the growth of building societies for many years to come. Prudential controls were tightened further but geographic expansion and diversification were not banned.

In the United States nationals began to appear in the 1880s. Unlike most associations, which were small, local institutions, they sought to attract funds by establishing branches throughout the United States and by using aggressive advertising and selling techniques. Not all nationals were outright frauds, but typically they were promotional ventures for the benefit of their organizers. They used misleading advertisements and door-to-door selling and paid high commissions to agents. They charged stiff membership fees and various expense fees for insurance and other overhead costs. And they imposed heavy fines on late payers and profited from forfeiture of sums paid on lapsed shares. Because they made loans on extremely risky projects at very high interest rates and because they managed their assets poorly, nationals were among the first to fail when the 1893 depression hit.

The failure of the largest national, the Southern Building and Loan Association of Knoxville, Tennessee in 1897, had an adverse impact on the whole movement. Responding to strong complaints by local associations, many states enacted regulations that required building and loan associations to confine their operations to local areas. This regulation was in line with the geographic limits imposed on commercial banks and reflected widespread populist concerns about out-of-state financial institutions. But at the same time these rules prevented savings and loan associations from geographically diversifying their loan portfolios.

After the turn of the century and until the onset of the Great Depression, both building societies and savings and loan associations expanded rapidly, especially during the boom years of the 1920s. Institutions in both countries refined their instruments in response to the volatility of interest rates caused by World War I and the growing competition on deposits from commercial and savings banks. During this period the use of variable-rate mortgage loans started to spread, while strong emphasis was placed on promoting home ownership and thrift.

At that time building societies and savings and loan associations were the only types of lenders that provided mortgage loans for maturities in excess of ten years, based on regular repayment, either through the share-accumulation-sinking-fund method or through reducing self-amortizing balance loans. Most other lenders (commercial banks, savings banks, and insurance companies) provided loans for shorter periods, say up to five years, with bullet repayment provisions and thus no regular amortization, and often with the right of recall. This practice has been attributed to the information and enforcement costs that lenders faced (Snowden and Bu-Saba 1992). These costs were lower for building societies and savings and loan associations in which members had some common bond. And thus these institutions were better able to increase the maturity of their loans.

Two additional factors explaining this difference include government regulations, especially important in the United States, where commercial banks were not yet permitted to engage in longer-term mortgages, and the orientation and marketing philosophies of commercial banks, which emphasized short-term lending. Commercial banks had plenty of opportunities to expand their loan portfolios without needing to focus on long-term mortgages.

Practice in the United States changed after the measures taken during the Great Depression. These included government insurance and guarantees for twenty-year and then thirty-year loans at fixed rates, a practice that proved catastrophic for savings and loan associations in the 1970s and 1980s (Vittas 1992). In the United Kingdom the large commercial banks continued to abstain from mortgage lending up to the late 1970s. In large part this was caused by their reluctance to borrow short and lend long and their failure to appreciate that lending long at variable rates, a practice that building societies had perfected over time, avoided the interest rate exposures that concerned them most. Commercial banks changed their approach in the 1980s, aided in part by the abolition of lending controls and the declining opportunities for growth in corporate lending—a result of the advent of securitization and other institutional changes.

Credit Unions

Credit unions were developed in North America in the early part of the twentieth century. They were designed as an extension of the credit cooperatives that thrived in Germany at the end of the nineteenth century. The term "credit union" is often used interchangeably with "credit cooperative." For the purposes of this chapter, I distinguish credit unions by their orientation toward consumer credit (and more recently

toward housing finance), and credit cooperatives by their orientation toward small traders, artisans, and farmers.⁷

Credit unions were promoted in North America by Alphonse Desjardins, who founded these institutions in Quebec and other Canadian provinces and then established the first credit union in New Hampshire in 1909. Credit unions were created to provide more-convenient and less-expensive credit facilities to their members, who were mostly salaried employees and factory workers. They were formed on the basis of a common bond among their members, which lowered their monitoring costs. They also benefitted from low transaction costs because they often operated from offices and factories, not needing to build extensive networks or engage in expensive advertising campaigns.⁸

Credit unions were promoted heavily in Canada and the United States by their proponents, and they prospered because they provided small loans at reasonable interest rates and at the same time paid relatively high dividends on members' credit balances. There were more than 1,300 credit unions in the United States in 1930, holding less than \$50 million in assets. But their number increased substantially after World War II. At one point there were more than 25,000 operating, but their number has declined in recent years. Today there are slightly more than 12,000.

⁷But the distinction between credit cooperatives and credit unions as well as that between credit cooperatives and savings banks is difficult to establish in practice and may reflect differences in terminology rather than function.

⁸To the extent that credit unions specialize in consumer credit they represent a formal extension of rotating savings and credit associations. These are found in most countries, especially countries in the early stages of financial development and facilitate saving for relatively large consumer expenditures. Rotating savings and credit associations involve a small number of individuals, typically from six to forty, who pay a regular amount on a periodic basis into a common pool that is then made available to each member in rotation. Because of their small size, rotating savings and credit associations rely on a common bond among participants, often their place of employment or a neighborhood or membership of a local church or a local club. Rotating savings and credit associations are often associated with social gatherings, similar in concept to the early, terminating building societies.

In Canada there are nearly 1,100 credit unions. Credit unions are much smaller in other Anglo-American countries such as Australia and Ireland, and particularly small in the United Kingdom and New Zealand, where they have been squeezed out by commercial banks (with large branch networks and a strong retail presence), savings banks, and building societies. Credit unions have not emerged as a distinct group in continental European countries, mainly because their activities have been subsumed in the credit cooperatives that also serve traders, artisans, and farmers.

Evaluation And Relevance For Developing Countries

Several factors shaped the emergence and growth of these institutions in different countries, including perceived gaps in financial markets, the institutions' rapid spread in neighboring and even distant countries, the role of leadership with integrity and vision in promoting their establishment, the change in orientation in the early stages of their development, and the operating efficiency and comparative advantage they enjoyed over other institutions.

Common Influences

The general success and growth record of thrift deposit institutions in the eighteenth, nineteenth, and much of the twentieth century suggest that the gaps in the market for financial services were real and that these institutions had the wherewithal to make a positive contribution to financial sector development. The perceived gaps in the supply of financial services emanated from the specialization of commercial banks in dealing with industrial and commercial companies and their reluctance to seek the business of middle- and low-income people or artisans, small traders, and farmers. Today, the unwillingness of commercial banks to provide financial services to these groups is attributed to the problems caused by high information and monitoring costs as well as the weak enforcement mechanisms that characterized these segments of the

market in earlier periods. The relative success of thrift deposit institutions is explained by their ability to overcome these problems.

But an additional, and not necessarily exclusive, explanation holds that commercial banks found it more profitable to deal with the business sector (and wealthy individuals) and did not have the organizational capacity and incentives to expand into small-firm, household, or rural banking. In other words, given their financial and human resources, commercial banks had more than enough to do in trade and working-capital finance. They had little incentive to expand into more-risky activities, such as term finance and mortgage banking, or in the mass banking business that required a much bigger investment in infrastructure and would have swamped their facilities if it was pursued without expanding their branch networks.

What was remarkable about the institutional innovations seen in the different types of thrift deposit institutions was their rapid spread in neighboring and distant countries. Today, the spread of ideas is explained by the extensive communications links between different countries and the globalization of markets. Initiatives to create mutual funds and financial futures markets around the world, let alone pension funds based on individual retirement accounts, are examples of how fast and how far new ideas can travel these days. International acceptance of privatization and economic deregulation within less than fifteen years is another example. The work of institutions like the World Bank also contributes to the faster propagation of these ideas. In earlier periods news traveled at a much slower pace and the rate of diffusion was measured in decades rather than years. But the spread was still quite remarkable given the mass communications technology that prevailed at the time.

Individuals that provided inspiration and leadership in first creating and then propagating the spread of different types of thrift deposit institutions were crucially important in most countries. These individuals were instrumental in establishing the fundamental principles of operation of different institutions and in

ensuring their success at the initial stages of their development. Of course there were individual leaders who exploited these institutions for personal gain and who behaved imprudently and even fraudulently. But once these institutions were well established, their survival was secured as long as they continued to serve a useful purpose and as long as there were enough managers with honesty and integrity to see the institutions through temporary crises and enable them to resume their growth. The experience of building societies in the United Kingdom is characteristic in this respect. Despite repeated crises and failures because of fraud and mismanagement, the good forces in the movement were able to prevail in the long run and led building societies to a very high level of achievement.

Another interesting feature that was common among thrift deposit institutions was their change of orientation at an early stage of development. Savings banks were created to encourage the poor to save, but in most countries they quickly reoriented their services to middle-income people and, if allowed, expanded into lending. In the United States savings banks became major lenders to large industrial firms and had very close links and extensive interlocking directorships with commercial banks and insurance companies. In Germany savings banks became the banks of the middle classes and developed close relations with the small and medium-size firms that are the backbone of German industry.

Building societies and savings and loan associations also changed their orientation from being formalized, long-term money clubs helping their members to acquire a house into institutions that promoted thrift as well as home ownership. The formal change in orientation came with the advent of the permanent institutions that permitted the separation of borrowers and investors. Credit cooperatives stayed closer to their original orientation—providing credit to their members—particularly for as long as they maintained unlimited liability. But after the adoption of limited liability, credit cooperatives became more similar to other financial institutions, although still retaining a localized character, which was facilitated in Germany and some other countries by their three-tier structure.

Also common was the lower transaction and information costs of thrift deposit institutions compared with other financial institutions (commercial banks or insurance companies). Lower transaction costs resulted from the use of unpaid managers and other staff, particularly in their early years of operation, and the lack of a need to build expensive infrastructures or incur other operating costs, such as advertising or publicity. Lower information costs stemmed from the local nature of their operations and the common links among their members, which allowed them to overcome the problems caused by informational deficiencies and weak enforcement mechanisms. Lower information costs implied lower operating expenses in screening borrowers and lower loan losses from defaulting borrowers. Together with lower transaction costs, they offered much smaller spreads, making thrift deposit institutions more competitive than traditional moneylenders. The comparative advantage of commercial banks and insurance companies lied more in making services available (such as deposit facilities for low balances, long-term credits, including housing finance, and so on) rather than in lower spreads or lower loan charges. An additional competitive advantage was obtained from the fiscal incentives, particularly the exemption from income taxes, that thrift deposit institutions had long enjoyed in most countries.

Differences Among Thrift Deposit Institutions

Not all types of thrift deposit institutions thrived in all countries under review. But even if they took root, different institutions followed different development paths in different countries. Four main factors may account for these differences. The first was the structure of market gaps, which was itself the result of a dynamic interaction between functions and institutions. The second factor was related to the size and distribution of wealth. The third factor was cultural differences, including education and literacy. And the fourth factor was differences in organizational approach, especially the presence or absence of the three-tier structure.

The structure of market gaps and the interaction between functions and institutions probably explain why building societies and savings and loan associations thrived in the United Kingdom and the United States, but not in continental Europe. They also explain why, in contrast, credit cooperatives thrived in Europe but not in Anglo-American countries. Economists have argued that informational deficiencies and weak enforcement mechanisms explain why commercial banks were not more active in term finance and mortgage banking or in dealing with artisans, farmers, and poorer households. But this analysis does not explain why commercial banks in Anglo-American countries did expand into some retail banking business in the nineteenth century, while those of continental Europe specialized almost exclusively in what could be called corporate or wholesale banking.

Considering the organizational capacity of commercial banks in terms of their financial and human resources and their ability to respond to opportunities for profitable expansion provides another way to explain the structure of market gaps. Thus, commercial banks in Anglo-American countries, where large companies were able to obtain finance from nonbank sources, oriented themselves toward the retail market and built relatively larger branch networks that allowed them to develop relations with smaller firms. In Central and northern European countries, in the absence of active securities markets and other sources of corporate finance, commercial banks maintained closer relations with larger companies and neglected households and small and medium-size firms.

As a result there was greater scope for savings banks and credit cooperatives to emerge and grow in continental Europe. But once these institutions were established, there was less room for building societies to take root and grow, as savings banks and credit cooperatives were able to fill the gap in the provision of housing finance to relatively wealthy households.

In the United Kingdom the role of building societies was strengthened by the investment restrictions that were imposed on the trustee savings banks. In France, although savings banks were equally

restricted, another type of institution—mortgage credit banks—was created to fill the gap in mortgage banking. As a result, building societies have always played a very small part in the French financial system. Building societies have appeared in Germany, but despite benefiting from large fiscal incentives, their role has been secondary to that of mortgage credit banks and other thrift deposit institutions. Another example of the effect of the sequencing of institutional innovations is the creation of the Post Office Savings Bank in the United Kingdom and Ireland, which narrowed the scope for urban and rural credit cooperatives in these two countries.

The structure of market gaps and the interaction between functions and institutions may also explain why, despite perennial criticisms of commercial banks in many Anglo-American countries for failing to provide adequate services to small and medium-size firms, there have not been any serious attempts to create mutual banks lending to such firms. The scope for profitable operations by any such banks would clearly be restricted by the ability of low-risk firms to bank with existing commercial banks rather than join in a venture that would end up subsidizing high-risk firms.

In addition to the structure of market gaps, the size and distribution of wealth is also an important determinant of scope, not only for thrift deposit institutions but for all types of financial services. Poor people seek a safe place to keep their meager savings. A postal savings bank with its convenient network of post offices that maintains the real value of such savings would be the ideal institution. But as income and wealth grow, demand for financial services increases and becomes more sophisticated. One of the most recent trends in the financial structure of OECD countries—the growing relative importance of pension and mutual funds—is in many respects a reflection of the growth of the financial wealth of these countries.

The distribution of wealth also affects financial structure. In developing countries, where wealth is highly concentrated, the demand for the services of thrift deposit institutions is very small. The distribution of wealth also has implications for the organization of thrift deposit institutions. For example, in Ireland

attempts to create rural credit cooperatives with unlimited liability failed because large landowners were reluctant to assume unlimited liability for the debts of small landowners. As seen from the experience of Germany, such cooperatives have a greater chance of success in communities with a more equal distribution of land holdings.

The experience of rural credit cooperatives in Ireland also underscores the importance of cultural factors. As discussed above, farmers in Ireland were allegedly reluctant to borrow from credit cooperatives because they did not want their neighbors to know what their financial condition was. In contrast, farmers in Germany were happier borrowing from their local cooperative rather than applying for a loan from a commercial or savings bank. But a more important aspect of cultural differences was the apparent reluctance of Irish farmers to deposit funds with the credit cooperatives because they were afraid that when their neighbors would find out about their deposits they would ask them for a loan or at least to cosign a loan. This reluctance to divulge details about financial wealth appears to be important in poor communities in Africa and Asia.

Another cultural aspect that affected the operation of credit cooperatives in Ireland was the reluctance of members to impose strict discipline on defaulting borrowers. This weakened the benefits of peer monitoring and pressure in maintaining the low level of loan defaults and loan losses that characterized rural credit cooperatives in continental Europe. In this respect it is important to note the emphasis placed on literacy and education by the American Commission that investigated agricultural conditions in Europe. A high level of literacy and acceptance of the mutual benefits of peer monitoring and high loan repayment rates are essential for the success of any type of thrift deposit institution. Although most proponents of such institutions emphasize self-help and independence from government interference, they have accepted such support for education and publicity.

Cultural differences probably also explain the emergence of the three-tier structure in most European countries and Canada, where the credit union movement has been strongly influenced by developments in Germany and France, and their absence in Anglo-American countries. One of the great strengths of thrift deposit institutions in continental Europe was the development of the three-tier structure. Over time, this structure created of a kind of informal deposit insurance scheme whereby weak links in the group would be rescued from failure but would be subject to strict discipline and the threat of expulsion if internal controls were not acceptable. This behavior was no different from that of the head office and branches of a commercial bank. The main difference lay in the greater autonomy of local institutions to make decisions affecting their local market and therefore their greater identification with and support of local developments. In Anglo-American countries the three-tier structure did not emerge, partly because of the antagonistic behavior of most leading institutions and partly because of regulatory restrictions. Regulatory restrictions were more important in the United States and resulted in a geographic concentration of risk that was aggravated by the failure to prevent the assumption of large interest rate risks by most savings and loan associations. The fear of centralized power was also a factor, especially in the United States, where even today credit union leaders oppose the creation of a three-tier structure.

Despite their differences, thrift deposit institutions were able to gain substantial market shares, not only in the markets in which they specialized, such as mortgage loans or rural deposits, but also in the overall market for financial intermediation services. But they have come under increasing pressure in recent years from four main sources. First, changes in the size and distribution of financial wealth have meant a growing demand for the services of pension and mutual funds. The clear implication of this trend is that even if their size does not decline in absolute terms, thrift deposit institutions are bound to suffer a decline in their relative importance. Some of the markets they served so well may be better served by institutional investors, using new securitized instruments that are more suitable to their requirements than

those of thrifts. Second, the advent of securitization and loss of corporate business by commercial banks has prompted a reorientation toward providing retail financial services to both smaller firms and households, thus increasing the competitive pressures on thrifts. Third, changes in technology, both transaction technology and information technology, have reduced, if not completely eliminated, the past comparative advantages of thrift deposit institutions in this area. Fourth, concomitant changes in financial regulation have removed the barriers between different types of institutions. In fact, the right given to thrift deposit institutions to diversify into other financial services has implied an increased demand for external capital, which has been one of the factors motivating the recent spate of conversions into stock ownership. And diversification into new services has further weakened the already flimsy link of mutuality that characterizes modern thrift deposit institutions.

Relevance for Developing Countries

Most developing countries have established some type of thrift deposit institution, but achieved mostly unsatisfactory results. For example, postal savings banks have been created in most countries of Africa and Asia. In Africa postal savings have suffered from high inflation and high negative real interest rates that have eroded the real value of deposits. In Asia postal savings banks have met with considerable success in some countries, but in other countries their record has been mediocre. Building societies have been formed in former British colonies in both Africa and Asia, and savings and loan associations in Latin America. But again their performance has been poor, suffering from the effects of high inflation and low recovery rates. Finally, credit cooperatives and credit unions have been tried in many developing countries, but their performance has suffered from low availability of external funds—funds not mobilized by their membership—and from poor monitoring of loans. Savings banks and credit cooperatives exist in most former socialist countries of Eastern Europe, where their roots date from the precommunist era. But their

operations and performance bear little resemblance to the original function of these banks. In most socialist countries savings banks had monopoly power over household banking, while credit cooperatives operated as branches of a state-controlled central agricultural bank.

Despite their poor record, thrift deposit institutions can still make a positive contribution to financial sector and economic development in developing countries. Thus provided macroeconomic policies succeed in lowering inflation to moderate levels, postal savings banks could mobilize deposits from poorer areas where there may be few, if any, commercial bank branches. Housing finance institutions could still be a useful institution in countries where the commercial banks are oriented toward the corporate sector and mortgage securitization may take some time to develop. Rural credit cooperatives could play a large part in providing financial services and distributing credits to small farmers, again, especially in countries where commercial banks have small branch networks and are unlikely to be successful in accessing these markets.

Many developing countries have created institutions that specialize in lending to the poor, especially in rural areas. Examples include the well-known Grameen Bank in Bangladesh, the Bank Rakyat Indonesia and its Unit Desa network in Indonesia, the Banco de Desarrollo (a bank created and funded by the Catholic Church) in Chile, Finagro in Ecuador, reorganized credit unions in Guatemala, and the stockvels in South Africa. But much more needs to be done to increase the effectiveness of such institutions in reaching the poor in rural areas and in helping small farmers, artisans, and traders.

The experience of developed countries with thrift deposit institutions suggests that five elements should be included in any integrated program to build solid and successful institutions. The first element is strong leadership. This implies that support should be given to those groups, such as the Church or local officials, that are likely to attract people with high ideals, integrity, and commitment to the success of these institutions.

The second element is the creation of a three-tier structure. The third element is a strong emphasis on education and dissemination of information about the workings and benefits of these institutions. As was seen from the experience of Ireland, culture can be an important obstacle to the success of thrift deposit institutions.

The fourth, and perhaps most important, element is the encouragement of active peer monitoring and enforcement of contractual obligations. While the principle of unlimited liability may not be viable in most developing countries, government policies could strengthen monitoring and enforcement processes by providing financial support only to regional units and local institutions that have a good record of loan repayment.

Finally, official policy toward thrift deposit institutions must encourage self help and avoid total reliance on external funding. External support could be made dependent on the level of resource mobilization attained by each local institution as well as on its record of monitoring and repayment.

Of course, the recent trends of financial systems in industrial countries toward securitization, pension funds, and mutual funds; reorientation of commercial banks toward the household and small-firms; and new transaction and information technologies will eventually affect financial systems in developing countries. The new financial, technological, and regulatory environments that are likely to emerge will limit the scope for some thrift deposit institutions. Nevertheless, given the prevalence of poverty and the underdevelopment of financial infrastructure in most developing countries, the need for institutions that specialize in offering banking services to the poor is likely to persist for a long time.

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Table 9.1**Institutional Shares in Deposits and Other Liabilities with Nonfinancial Sector, 1975**

| | France | Germany | Italy | Japan | Netherlan | Sweden | Switzerlan 7.3 | U.K. | U.S. |
|-------------------|--------|---------|-------|-------|-----------|--------|-------------------|------|------|
| Central bank | 8.3 | 5.4 | 8.1 | 4.3 | 6.6 | 7.0 | 16.5 | 3.9 | 4.2 |
| Large comm. banks | 18.1 | 7.8 | 17.4 | 20.5 | 15.2 | 24.4 | 4.9 | 17.0 | 15.2 |
| Other comm. banks | 11.5 | 7.5 | 12.8 | 12.9 | 3.8 | 3.6 | 27.1 | 11.7 | 20.3 |
| Savings banks | 14.2 | 29.0 | 18.6 | 6.1 | 5.0 | 14.5 | — | 3.1 | 5.6 |
| Postal savings | 10.9 | 2.0 | 8.7 | 9.4 | 7.4 | 2.2 | 2.5 | 1.7 | — |
| Credit co-ops | 16.0 | 9.4 | 8.4 | 19.8 | 12.2 | 2.9 | — | — | — |
| Building soc. | — | 5.8 | — | — | — | — | — | 17.9 | 14.5 |
| Credit unions | — | — | — | — | — | — | 29.6 | — | 1.7 |
| All Thrifts | 41.1 | 46.2 | 35.7 | 35.3 | 24.6 | 19.6 | 1.3 | 22.7 | 21.8 |
| Long-term CIs | 8.2 | 12.8 | 9.1 | 11.0 | 5.0 | 2.8 | 12.1 | 4.9 | 5.5 |
| Insurance cos | 8.8 | 11.9 | 3.1 | 8.2 | 12.8 | 15.7 | 23.1 | 21.9 | 14.6 |
| Pension funds | — | — | — | 7.8 | 26.6 | 25.5 | 4.8 | 11.1 | 12.9 |
| Mutual funds | 2.5 | 1.4 | 0.3 | — | 2.4 | — | 0.4 | 6.5 | 2.3 |
| Other inst. | 0.5 | 7.0 | 3.5 | — | 3.0 | — | — | 0.2 | 3.2 |

Source: Vittas et al (1978).

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